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SIPDIS

NSC FOR TSHANNON AND CBARTON
ENERGY FOR D. PUMPHREY AND A. LOCKWOOD

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TAGS: EPET ECON VE
SUBJECT: GROWING PRESSURE FOR RENEGOTIATION OF OIL SERVICE CONTRACTS?

Classified By: AMB. CHARLES S. SHAPIRO; REASONS 1.4 (B) and (D)

SUMMARY

¶1. (C) There are signs that the GOV has started playing hardball in its efforts to force the oil companies that signed operating service agreements in the 1990's to convert these contracts into the majority GOV-owned joint ventures mandated under the 2001 Hydrocarbons Law. Public claims by the Minister of Energy and Mines that two companies have already signed agreements have been disputed but Harvest International, a U.S. independent, is currently evaluating two oil and gas fields located close to its existing fields and hopes to negotiate the first such agreement. ChevronTexaco, with the largest exposure of any U.S. company, is dismissive of any efforts by the GOV to bring pressure in this area but others confirm that in addition to the "carrot" of potential access to new fields for those companies that review their contracts, PDVSA has used the "stick" of refusing to approve capital expenditures proposed by some operators in their 2004 budgets and setting production constraints for 2004. For the Chavez government, a win on forcing companies to migrate into relationships under the 2001 Hydrocarbons Law may be more important than a "few" incremental barrels from the operating agreements. That said, we do not at this time expect the pressure to reach the point where the GOV would outright violate existing agreements although it could certainly make it more difficult for the companies to do business. End Summary.

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GOV GETS SERIOUS ABOUT PUSHING HYDROCARBONS LAW?
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¶2. (C) On January 12, Minister of Energy and Mines Rafael Ramirez_ said publicly that international operators in Venezuela will not be able to increase production without transferring their operating agreements to joint ventures under the terms of the 2001 Hydrocarbons Law. The Minister's comments have been followed by reports that PDVSA is not only refusing to approve capital expenditures proposed by the operators in their 2004 budgets but is setting production constraints for 2004. The GOV is also still refusing to authorize the 2003 transfer of British Petroleum's (BP) operating agreements for the DZO and Boqueron fields to French independent Perenco and is reportedly arguing that while the contracts with BP were grandfathered under the 2001 law, this would not apply if the contracts were transferred to Perenco. These events have sparked concern that the GOV has started playing hardball in its efforts to force the companies that signed operating service agreements in the 1990's to convert these contracts into the majority GOV-owned joint ventures mandated under the 2001 law.

BACKGROUND

¶2. (U) In the 1990's, PDVSA planned an ambitious expansion program to capture a greater share of global energy markets. An economically viable way to achieve this goal was for PDVSA to enter into operating contracts for the reactivation of marginal oil fields with foreign investors who had the much-needed capital. The result was 33 "Operating Agreements," granted in three investment "rounds." The foreign investors signed 20-year contracts to develop these fields at the investors' own expense.

¶3. (U) Under these contracts, the foreign investors receive a fee per barrel produced from PDVSA. Against this revenue, the investors may deduct the operating expenses (i.e, the "operating fee") incurred during the year. A "capital fee," to allow the recovery of capital expenditures incurred by the foreign investor on behalf of PDVSA, is also recoverable over ten years according to a complicated formula. The contracts typically provide for a maximum total fee that may be charged by the investor and recovered during any given year. Any fees allowable for the year, but not recovered because of the imposition of the maximum total fee, are carried forward to

the next year and subject to applicable interest and inflation rate adjustments until the costs are recovered by the investor. PDVSA pays royalties on the oil while the investor pays a 34 percent income tax.

¶4. (SBU) The Chavez government, however, has rolled back the expansionary policy of the 1990's and made clear it particularly dislikes the operating agreement contracts. This distaste was codified in the 2001 Hydrocarbons Law that stipulated that future private sector investment in the Venezuelan oil sector must be through joint venture agreements in which the GOV will take a minimum 51 percent stake. The law also increased most royalty payments from 16.67 percent to 30 percent and changed other aspects of the tax structure. Finally, the joint venture will not be able to commercialize the oil it produces, which must instead be sold through PDVSA or some other state entity. Although the joint venture model would potentially give a company an equity stake in the oil it produces that it does not have under the current service agreement model, the companies claim that the economics simply do not support investment in projects under the 2001 law. There have, to date, been no investments under the law and the GOV continues to complain about the administrative costs of managing the contracts and that the oil produced under the operating agreement contracts is "high cost" oil.

VINCCLER & TEIKOKU DISPUTE MINISTER,S REMARKS

¶5. (C) In his January 12 remarks, according to press reports, Ramirez_ went on to add that two companies, Japan's Teikoku and Vinccler, a majority Venezuelan-owned company with a U.S. component, had already negotiated conversion of their operating agreements to joint venture agreements with PDVSA. In subsequent conversations with econoff, executives with Vinccler and Teikoku confirmed on-going discussions with the GOV concerning new gas (not oil) opportunities in their fields but denied that any contracts have been signed. Vinccler Technical Manager Emilio Sanchez_ said the Ministry had proposed to the company in July 2003 that its current operating agreement for the Round II Falcon East block be converted into a gas license for the entire area of the block. Noting that the field produces less than 1,000 b/d, Sanchez_ said Vinccler is most interesting in expanding its business into the production of associated gas and, eventually, the development of off-shore gas. In these circumstances, work is ongoing on an agreement to modify the operating contract into an agreement for associated gas and liquids, under which Vinccler will be paid a flat fee for the liquids. Sanchez_ flatly denied, however, that Vinccler would agree to the 51-49 percent structure mandated by the Hydrocarbons Law.

¶6. (C) Matsuro Manabe, President of Teikoku Oil de Venezuela, confirmed to econoff on January 23 that Teikoku's current interests in Venezuela are also focused on gas opportunities. Teikoku currently has two operating agreements: the East Guarico field acquired in the first round and the second round Sanvi-Guere field. Production from the two fields totals about 6,000 b/d. Manabe explained that the company is already producing associated gas from the East Guarico field and that seismic data by PDVSA/Teikoku on an adjacent area north of the field shows great potential for further gas development.

A U.S. COMPANY HOPES TO BE THE FIRST

¶7. (SBU) A U.S. independent, Harvest International, does hope to be the first to negotiate a contract under the terms of the Hydrocarbons Law. Harvest has an 80 percent share in Benton-Vinccler, that has operated three small oil fields in southern Monagas state since signature of a first round operating service agreement in 1992. In November, Harvest announced that it had signed an agreement with PDVSA to undertake a six-month evaluation of two oil and gas fields (Temblador and El Salto) located close to its existing fields. Any agreement on the two new fields is likely to be accompanied by re-negotiation of the original operating services agreement.

¶8. (C) In a November conversation with econoff, Harvest CFO Steve Tholen said that Benton-Vinccler has one of the most profitable operating service contracts in Venezuela. Thus, it would be a public relations victory for PDVSA and the Ministry if they were able to announce that Harvest had agreed its operations could be profitable under the provisions of the 2001 law. The most complex part of the negotiation will cover the corporate structure. Tholen

emphasized that Harvest would insist on a structure that would allow the joint venture to focus on project economics and would allow Harvest to both book the reserves and have operating control (i.e., of such issues as the accounting rules). According to Tholen, Harvest envisions a structure where a majority government-owned joint venture company would in turn contract actual field operations to a company in which Harvest would hold the majority share. Benton-Vinccler employee John Paul McKee told econoff January 28 that the transfer of data from PDVSA needed for evaluation of the two fields has gone more slowly than anticipated but that the review is on-going.

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LAWYERS AGREE THAT RE-NEGOTIATION WOULD BE TOUGH
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¶9. (C) Econoff discussed the complexities of re-negotiating the operating agreement contracts with several local attorneys whose practices focus on energy law. They all agreed that it would be particularly difficult to quantify the sunk costs not yet re-paid under the capital fee. Steel Hector & Davis attorney Alfredo Anzola, however, confirmed February 9 that his firm has been contracted to draft a model joint venture agreement to guide CVP in its discussions with companies. Anzola added that CVP is "under a lot of pressure to advance this as quickly as possible" and said the model agreement would be provided to CVP that day. Anzola specifically informed econoff that the CVP had said "no" to what he called "sham structures" that would allow the private investor to control the joint venture operations.

CHEVRONTEXACO NOT CONCERNED...

¶10. (C) Econoff discussed the issue with ChevronTexaco de Venezuela President Ali Moshiri who confirmed that he has been asked informally if ChevronTexaco would be willing to convert its contracts. (Note: With substantial investment in the Round Two Boscan field, and the LL-652 field acquired in Round Three, ChevronTexaco could have more to lose than any other U.S. company from any push by the GOV to force the migration of the operating agreement contracts. End Note.) Moshiri said bluntly that he believes Ramirez_ was simply trying to make political points in his remarks of January 12. He added that he believes neither PDVSA nor the Ministry have legal staffs capable of handling such negotiations. (Note: Steel Hector & David attorney Anzola confirmed that the legal staff at CVP are all new hires; he does not know yet whether CVP will contract out the negotiating process.) When econoff informed Moshiri that the CVP has contracted with outside legal counsel to draft a model joint venture agreement, Moshiri emphasized that the important issue will not be the terms and conditions of any agreement but the economics of the deal. Saying "if we get equity barrels, the deal may not be bad," Moshiri said he would be interested to see what kind of offers would be made. He emphasized, however, that ChevronTexaco will not accept a deal that prejudices the economics of its operations.

BUT OTHERS ARE SOMEWHAT MORE SO

¶11. (C) Moshiri was also dismissive of reports that PDVSA is not only refusing to approve capital expenditures proposed by the operators in their 2004 budgets but is also setting production constraints for 2004. Moshiri said "they,re telling us to produce." In subsequent conversations,

however, ExxonMobil President Mark Ward and Williams General Manager Tim Penton confirmed these reports of problems with approvals of capital expenditures to econoff. (Note: ExxonMobil and Williams have non-operational shares in the second round Quiamare-La Ceiba and third round La Concepcion fields respectively.) Petrobras, which operates the La Concepcion field, reported in the January producers luncheon that PDVSA had approved its 2004 budget with severe cuts in capital and expenses as well as setting production limits below its current production level.

COMMENT

¶12. (C) There might seem to be a discrepancy between the GOV's need for every barrel it can lay its hands on versus a strategy in which it would take possible production cuts in order to force the producers to accept contract negotiations under the 2001 law. We believe, however, that for senior officials of the Chavez government a win on the 2001 Hydrocarbons Law may be more important than a "few" incremental barrels from the operating agreements. PDVSA

may, indeed, be losing money on some of these contracts. We do not at this time expect the pressure to reach the point where the GOV would outright violate the existing agreements. That said, however, the GOV could definitely make life more difficult for the companies.

¶13. (C) Companies other than Harvest are sure to bite if the carrot, perhaps in the form of payment of monies owed by PDVSA on their existing investments or new fields, is big enough. Steel Hector & David attorney Anzola believes Shell is likely to be the first company approached with the model draft, followed by Repsol.
SHAPIRO

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